# Hidden Leverage and a false sense of security

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*“ ‘Stability is destabilising’ as relative tranquillity encourages more risk taking and innovative behaviour that increases income even as it disrupts the conditions that generate ‘coherency’ and ‘tranquillity’. That is, the market forces that operate when a system is stable will push it toward instability, so that even if anything like an equilibrium could be achieved, it would set off behavioural responses that would quickly move the economy away from equilibrium.”*

Dimitri B Papadimitriou and L Randall Wray, *Minsky’s Stabilizing an unstable economy: two decades later.*

# New Century Financial

- Few thought subprime mortgage problem would not remain contained
- Business models were collapsing
- Short-term borrowing to fund churn of new business
- Spiral of decline contains all the themes of broader financial meltdown
- Liquidity, leverage and security

# Subprime's role

- Subprime market was not the cause of the meltdown, but it was the trigger
- It characterised a fever that gripped the financial system
- It was the first of a succession of traps to be triggered in an interconnected system

# Top dollar

- US has been the world's leading economy and the dollar its reserve currency
- It has been able to cut rates aggressively to boost its economy
- Asian disinflation and the savings glut supported The Great Moderation
- These factors crucial to appetite for leverage and international money flows

# Hunt for yield

- Low rate, high liquidity environment cuts returns for investors
- Dotcom stock market crash made fixed income more popular
- But corporate borrowing slowed
- Gave impetus to the growing securitisation industry

# Super-bubble

- Late 20th century also saw a huge growth in need for private pension provision
- Changed the role and size of capital markets

- All these things together behind the creation of what George Soros has called the “super-bubble”.

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*“[T]he positive impacts of such financial engineering (risk absorption capacity) can also encourage excessive risk taking, lending and borrowing based on ‘flat-world’ faith. Flat-world faith is a sense of false confidence that the superlative financial engineering of New Monetarism has ended economic and financial cycles.”*

David Roche and Bob McKee, *New Monetarism*

# End of history

- 1990s saw the triumph of Anglo-Saxon capitalism
- Created perfect conditions for its subsequent failures
- Growing appetite for risk, leverage and complexity
- LTCM and Enron were warnings

# Banking regulation

- Deregulation created the modern financial playing field
- Connected the dots between securities sales and trading, large balance sheets and loan origination
- With this mortgage securitisation would never have taken off
- Necessary – but not sufficient

# Unintended consequences 1

- Basel Accord and the focus on capital at risk
- Created opportunity for banks to profit by shunting loans off balance sheet
- Banks discovered that securitisation and derivatives boosted returns on equity
- Project reached its pinnacle with conduits and SIVs

# Unintended consequences 2

- Fair value or mark-to-market accounting
- Strong pro-cyclical impact on banking
- Rising asset values lead to aggressive balance sheet expansion
- Speed of expansion caused worst excesses

- Both developments led to step change in liquidity creation

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*"[P]erhaps after a quarter century of a bull market in credit asset values - brought on by the persistent decline in nominal interest rates caused, in sequence, by disinflation, productivity gains, and an extended period of abnormally low real rates - we should not be surprised that our financial system has been re-engineered into an asset-based process that presumes rather than inquires into the cash flows of borrowers."*

Peter Fisher, co-head of fixed income at Blackrock, in remarks to the Jackson Hole Symposium, August 2008.

# False sense of security

- Dominant culture of secured, or asset-based lending
- Expectations of rising collateral values means disregard for cash-flow analysis
- Credit ratings used uncritically as minimum requirement in lieu of diligence
- Complex products and speed of market only make sense if analysis disregarded

# Reverse gear

- False sense of security not only in complex products
- Also drove standards for lending to hedge funds and via repo markets to banks
- Poor knowledge of collateral helps explain rapid draining of liquidity
- Earliest victims had shortest funding terms

# The Earthquake

- Painful deleveraging was inevitable in late 2007
- September 2008 undermined most important assumption in banking…
- … that a bank would always be rescued
- Assumption influenced stress testing and rating agencies
- Then Lehman failed

# Things fall apart

- Lehman’s failure precipitated a run on the entire system
- UK led a series of massive bail-outs
- Armageddon averted – but crisis not over

- Biggest problem remains: How to manage a future world with fewer larger banks still incentivised to expect rescues